

Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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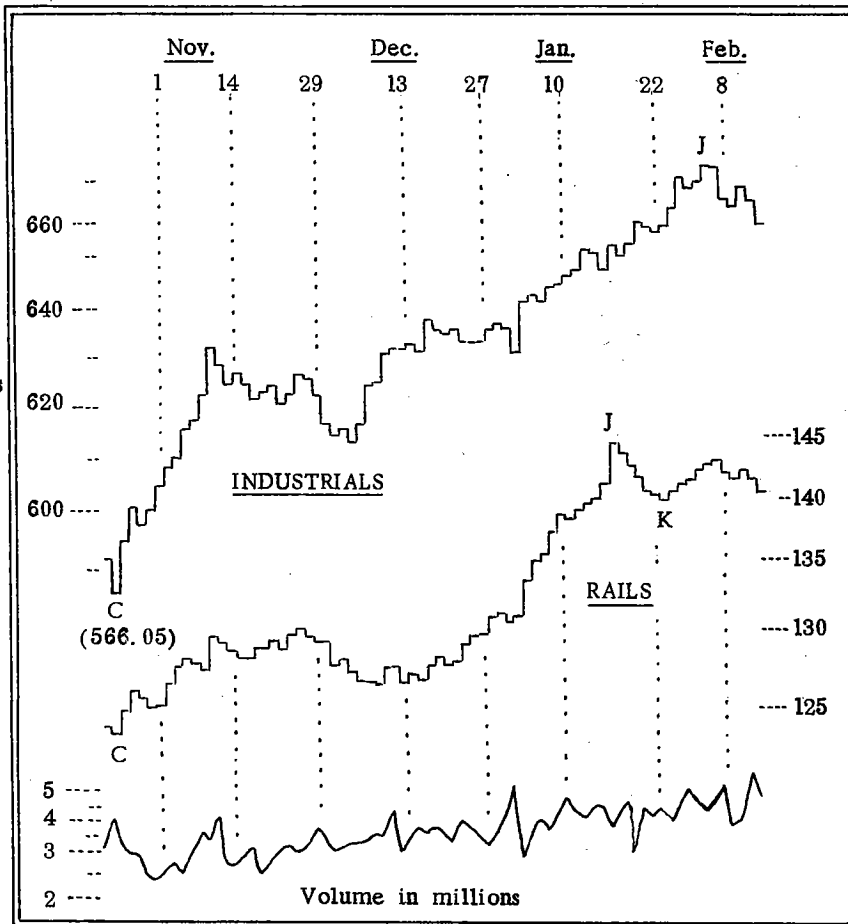
February 13, 1961

Number 133

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PRICE MOVEMENTS On January 18, Rails established a recovery high of 144.89 (J on chart); they then declined to 139.95 (K) before advancing again. Despite the faltering of the Rails, Industrials continued their rise until February 2 (J -- 653.62). This produced one of those minor non-confirmations which at times prove meaningless, at other times prove to be the first hint of impending danger. However, past market history suggests the wisdom of paying particular attention to any divergence or non-confirmation which comes within an area of heavy volume.

On February 9th both Averages declined to the accompaniment of the largest volume (5.59 million shares) in five years. On February 10th the Averages retreated again, and minor descending zig-zags were formed in both indicators. If Rails now violate point K (139.95) that Average will appear weaker than at any time since the September, 1960 low. A Rail closing below K with Industrials de-



STATISTICS ON 13 COMPLETED BEAR MARKETS (D-J INDUSTRIALS)

	From	To	Points Decline	Days Decline	% Decline	No. of Legs
1	4/4/99	6/23/00	22.36	445	29.4	4
2	9/19/02	11/9/03	25.62	416	37.8	3
3	1/19/06	11/15/07	50.00	665	48.5	4
4	11/19/09	7/26/10	26.91	249	26.8	2
5	9/30/12	12/24/14	40.98	815	43.5	4
6	11/21/16	12/19/17	44.20	393	40.1	3
7	11/3/19	8/24/21	55.72	660	46.6	6
8	9/3/29	7/8/32	339.95	1039	89.2	8
9	3/10/37	3/31/38	95.45	386	49.1	3
10	11/12/38	4/8/39	36.97	147	23.3	2
11	9/12/39	4/28/42	63.00	959	40.4	3
12	5/29/46	5/17/47	49.29	353	23.2	3
13	6/15/48	6/13/49	31.56	363	16.3	4
14	8/3/59	?	112.05	449	16.5	3
Average			67.69	530	39.6	

clining "in gear" would mean that the minor (and perhaps secondary) trend had turned down. A subsequent series of descending zig-zags in both Averages coupled with heavy volume would imply that the price structure was to receive its first important test since the bear market lows. Conversely, a refusal by Rails to violate K would be a very big plus in the current picture.

COMPARISONS A great many letters have arrived here recently, and they all ask the same question: "Has the bear market ended?" No one can know the final answer at this time; certainly the Averages have not yet rendered their decision. Until they do I intend to be guided by that principle of Dow Theory which states that the primary trend (in this case bearish) is taken to remain in force until reversed by an authoritative counter-signal.

The chart (page 1) provides statistics on the D-J Industrials during thirteen completed bear markets. A study of these statistics suggests that bear markets, like other illnesses, are subject to a great many variations.

Nothing in the table, in fact, would lead one to believe that a given bear market bears any relationship to any other. However, a relationship does seem to exist between a given bear market and its preceding bull market. Thus Rhea wrote: "A primary bear market is a long downward movement interrupted by important rallies. It is caused by various economic ills and does not terminate until stock prices have thoroughly discounted the worst that is apt to occur." Since these "various economic ills" occur during the preceding bull market, the general rule is that the greater the bull market the greater the probability of a subsequent severe bear market. Most bear markets last approximately half as long as the preceding bull markets, while only two bear markets in history (1899-1900, 1946-47) failed to wipe out at least 50% of all gains recorded by the preceding bull markets.

Note that the bear market which began in August, 1959, has (so far) been milder in terms of percentage of points lost than twelve of the thirteen previous bear markets. 449 days elapsed between August 3, 1959 (the top) and October 25, 1960. If, for the sake of argument, October 25 marked the end of the bear market for Industrials, then the entire decline was a rather short one. This is all the more unusual when we consider that the preceding bull market lasted ten years. Although only one previous bear market was more severe than 1959-60 in terms of total number of points lost, that fact loses significance when it is remembered that the 1959-60 decline started from the highest level ever reached by the D-J Industrials

What the foregoing statistics do suggest is that the decline which began in August, 1959 has (so far) been sub-average both in duration and extent when compared with the average of thirteen preceding bear markets. Moreover, since the 1949-59 bull market was a record-breaker both in terms of duration and number of points gained, one can only remain somewhat dubious as to whether the September-October, 1960 lows represented a full correction of whatever ills have been built into the economy during the years since 1949.

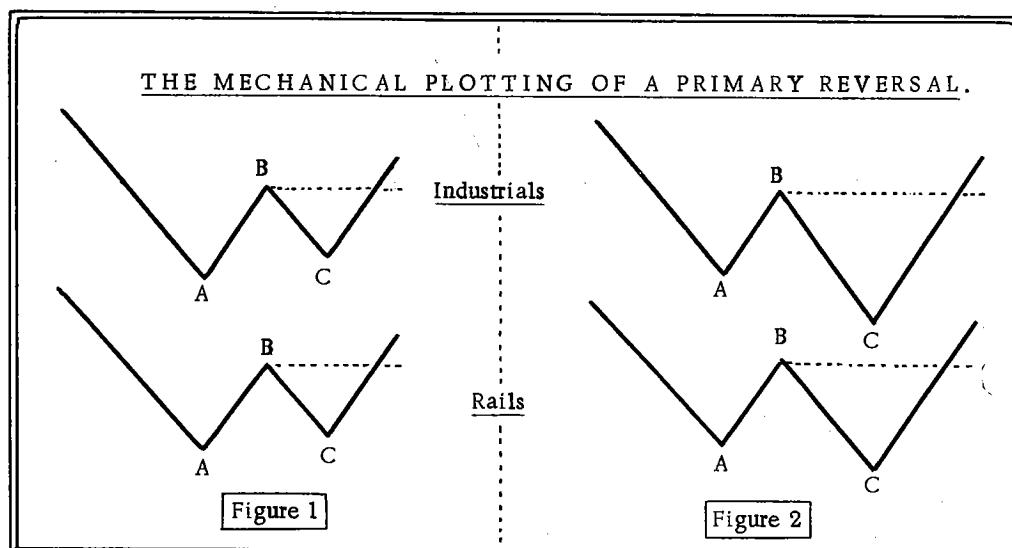
PRIMARY CHANGES As this Letter is written, Industrials are 16 points below their peak at J, Rails 4.5 points below their comparable J high. Bullish views are usually discussed to best advantage (sans emotions) in a declining market. For this reason, I will use the following section for a survey of the bullish possibilities.

Robert Rhea recognized two formations as signifying the turn from a bear to a bull market. These two formations are shown on the accompanying chart. In Figure 1 both Averages decline to bear market lows at point A. Following A, a rally commences (A-B) which, for want of more conclusive evidence, we classify as an upward reaction in a continuing bear market. A decline (B-C) ensues which lasts at least two or three weeks and which corrects about 1/3 to 2/3 of the A-B advance. On the B-C decline one or both Averages hold above the previous lows at A. It is what occurs after C that is important. If, on the next advance, both Averages better the preceding highs (at B) the primary trend is taken to have turned from bear to bull. In this case we go back and reclassify the A-B advance as the first primary leg in a new bull market; the B-C decline then becomes the first reaction in the new bull market, and the advance from C becomes the second primary bull leg.

In figure 2 we see a more unusual formation and one which is in many ways less satisfactory. Nevertheless, Rhea accepted the formation in Figure 2 as implying a change in the primary direction. On the decline to A, bear market lows are recorded. An upward reaction ensues (A-B), followed by a further decline which takes both Averages to new bear market lows at C. At C there is little to suggest that the primary trend has turned (except, perhaps, for a drastic diminution in volume). Subsequent to the C lows both Averages turn up and advance steadily (with little or no correction). At the point where the preceding secondary highs (B) are bettered by both Averages the primary trend is considered to have changed from bear to bull.

In the present situation secondary highs were established by Rails in March, 1960 (146.56), by Industrials in June, 1960 (656.42). These secondary highs correspond to the B points in Figure 2. Under this line of reasoning, a good case could be made for a change in the primary direction if the two Averages better the 656.42 and 146.56 points. Final proof of a change from a bear to bull market would come if, after the bettering of the 656.42 and 146.56 highs, both Averages eventually succeed in hurdling the 1959-60 bull market highs of 685.47 and 173.56

One might ask whether purchases would be warranted in the event that either of



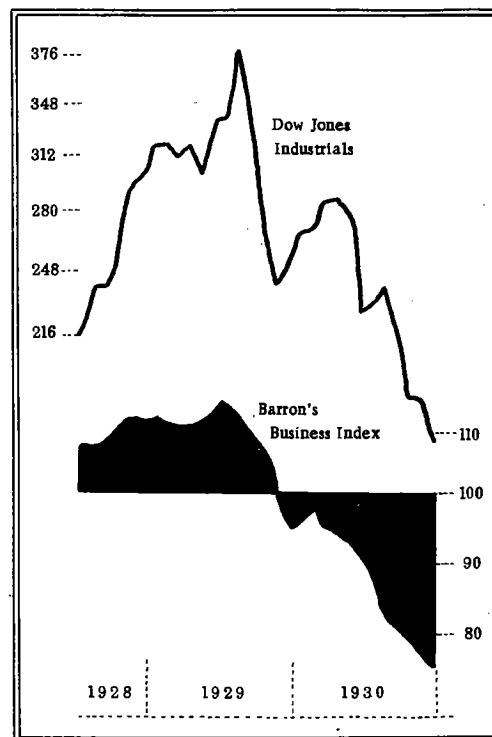
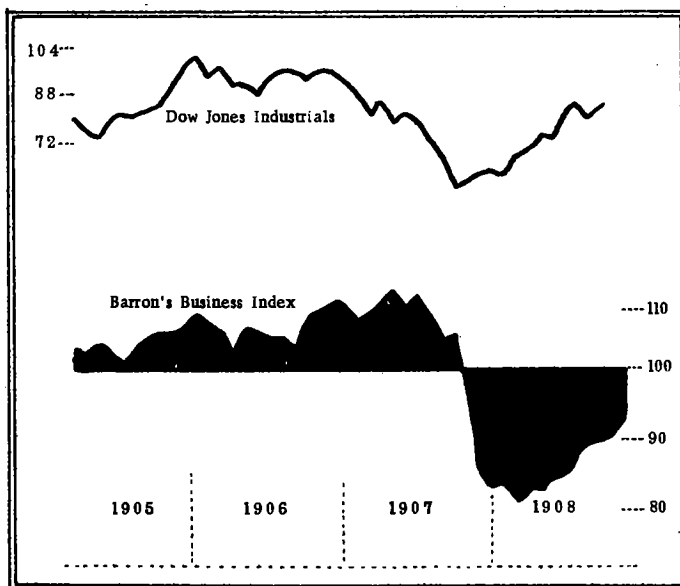
the bull structures (Figure 1 or 2) appear in the Averages. (1) If the Averages now decline and fully correct the advance since the bear market lows, and if selling dries up drastically as the Averages work lower, the implication would be that there would be another attempt to approach or better the secondary highs of 656.42 and 146.56. In other words, a low-volume decline would provide traders with an opportunity to "jump the gun" and take on speculative commitments in the hope that the next rally would provide a bull signal. Such purchases would have to be made with the stipulation that they would be sold if the rally showed signs of reversing. (2) However, if no worthwhile correction appears, and if the Averages simply turn up and better the secondary highs of 656.42 and 146.56 the odds would then favor a further substantial rise. In other words, an immediate bettering of the 1960 secondary highs would provide another (although decidedly less advantageous) buying signal.

It is well to remember that in both cases stocks would have to be purchased at historically "high" levels. They would also have to be bought at levels where (1) the general market appears to be overvalued, (2) average yields are low, (3) the short interest ratio is under 1 and still declining, (4) a mechanical bull signal has been given following an almost non-existent "base", following an area which displayed none of the usual characteristics of bear market bottoms, and following a bear market which was sub-normal in duration and extent.

While it is true that bull signals usually touch off worthwhile advances, I am moved to caution in the present situation by one of Dow's basic tenets, namely, that "... prices are controlled by values in the long run." A friend who is a veteran Dow Theorist writes: "The true investment approach will work well in every kind of market. It seeks proven investment values, adjusts to historic extremes, and protects income by protecting capital. The successful investor buys well to sell at very high prices." A test of values which I use is as follows: If, after purchasing a group of stocks, the market turned down, would I be satisfied to sit with those purchases in the knowledge that they represented values? While this test may seem naive in the present area of excited speculation, I submit that this is a test that has worked well in the past and will continue to work in the future.

DECEPTIVE PERIODS One of the costliest mistakes which can be made by the businessman or investor is to jump to hasty (and often improper) conclusions regarding the direction of the primary trend. The sixty-five year record of the D-J Industrial Average superimposed upon Barron's Business Index makes a fascinating and informative study. I have taken two earlier periods from my charts to illustrate the type of mistake which has, in the past, proved disastrous.

On January 22, 1906, a great bull market recorded its highs. A bear signal was given in April, 1906, following which both Averages dropped to lows, only to turn up and begin what was to be an extended and excited advance. In August, 1906, a false bull signal was given as both Averages rose above their preceding secondary highs. It is of great interest that Hamilton did not accept this "signal" as the confirmation of a new bull market but demanded new highs in both Averages before reversing his decision. By December, 1906, Industrials had climbed within 8 points of their previous bull market high, Rails (the higher-priced and more important Average in those days) to within 1.30 points of their previous bull market high! To make matters even more difficult, business actually improved throughout 1906 and the first half of 1907 (see chart) but towards the latter half of 1907 both Averages collapsed together with Barron's Business Index.



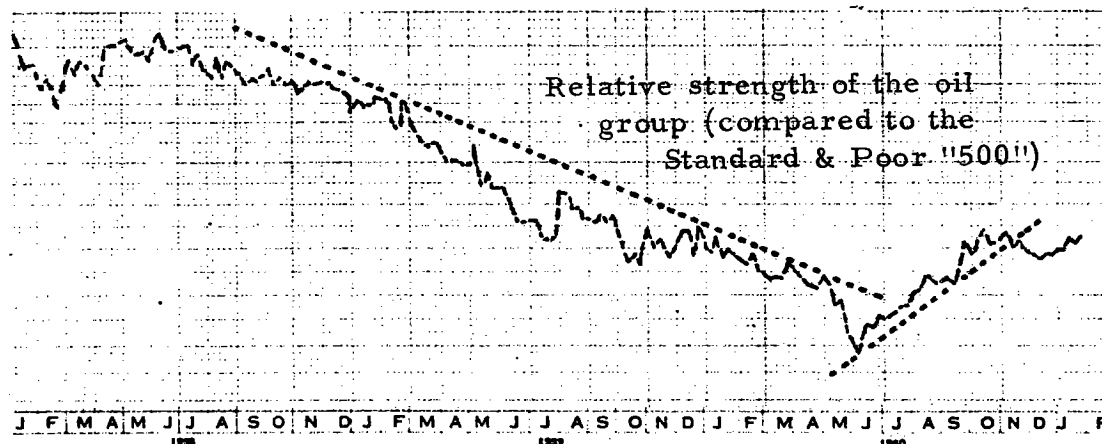
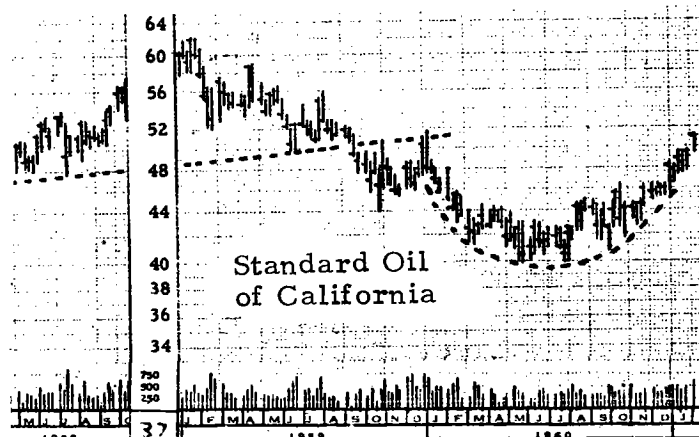
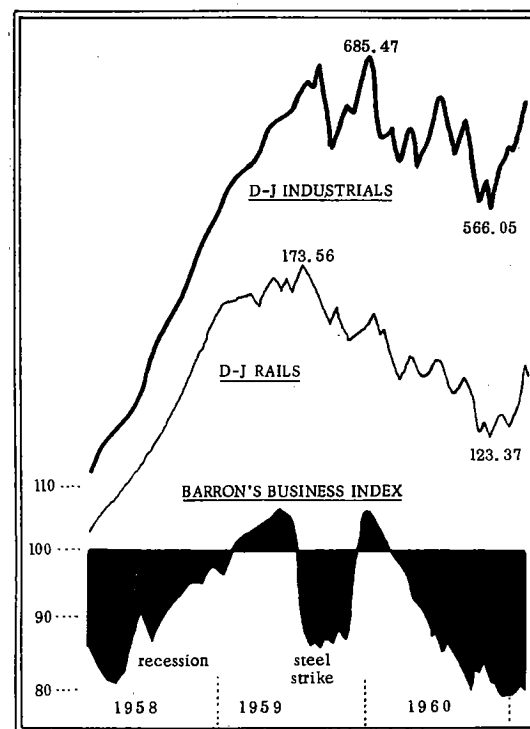
In 1930 following the 1929 "crash", both Averages advanced in a movement which served to turn the entire investment world optimistic again. A false bull signal was given in February, 1930, as preceding secondary highs were hurdled. After another decline the February peaks were jointly bettered to the accompaniment of huge volume. Business turned up slightly in early 1930 (see chart), but the entire movement proved to be false, and towards May, 1930, the Averages and Barron's Business Index turned down again in what was to be the worst collapse in history.

In the present situation no one can be positive of what a seemingly "bullish" bettering of the 656.42 and 146.56 secondary highs may mean, but there is ample precedent for treating such a "signal" with care. The 96 point Industrial advance in 1930 produced only a slight and deceptive rise in business, and the only hint that the move was false was (1) the lack of evidence to suggest that a normal bear market bottom had been established, and (2) the fact that an eight year bull market would seem to warrant a subsequent bear market of at least a few years' duration.

STOCKS The relative strength of the oil group is shown on the chart below. This group turned down and performed worse than the market from June, 1958, to June, 1960. This was one of the longest periods of poor relative strength of any group on the "Board". In June, 1960, the oil group turned up, and the long downtrend in relative strength was reversed in July, 1960. It is therefore a little disconcerting to see the freshly established upward trend broken in November, 1960, after a rise of only four months. It is possible that a new and shallower rising trendline will be established, but oils should be watched closely at this point.

The weekly chart of Standard of California shows one of the most massive "rounding bottoms" to be seen on any stock now being traded. As a rule this type of formation is associated with fundamental turns, but as seen on the chart, the stock is only now "chewing" into some of the "supply" resulting from the huge distribution formation which was formed during 1958 and 1959.

(Written Monday, February 13th - 3 P.M.)



Charts courtesy of Traders Research, Box 6185, Lambert Airport, Mo.